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The SEC's Concept Release on Exempt Offerings: Will it Create Harmony?

PLI Webinar

October 2019

Agenda

- The SEC's Concept Release on Harmonization of Securities Offering Exemptions
- Traditional private placements conducted under Section 4(a)(2) and Rule 506(b),
- The evolution of general solicitation and Rule 506(c),
- Choosing among a Regulation A, a crowdfunded, and a Rule 506(c) offering,
- The motivations for using one of these approaches over another,
- Integration of offerings in close proximity to one another and the changes in integration analyses over the years,
- Investor qualifications, sophistication, and disclosure, and
- Resale exemptions

Concept Release

Concept Release on Harmonization of Securities Offering Exemptions

- On June 18, 2019, the US Securities and Exchange Commission (SEC) issued a concept release soliciting "comment on possible ways to simplify, harmonize, and improve the exempt offering framework to promote capital formation and expand investment opportunities while maintaining appropriate investor protections."
- Under the Securities Act of 1933, as amended (Securities Act), every offer and sale of securities must be registered with the SEC unless an exemption from registration is available.
- In the concept release, the SEC specifically notes that the overall framework for exempt offerings has, particularly recently, changed significantly due to the introduction, expansion, or revision of various exemptions.

Concept Release on Harmonization of Securities Offering Exemptions

- The concept release does not contain specific rule proposals. Rather, the SEC seeks public comment on whether there are:
  - Ways to make the exemption framework more consistent, accessible and effective in application;
  - Ways to simplify the complexity that now exists in the exempt offering framework;
  - Gaps in the exempt offering framework that make it difficult for some companies to rely on an exemption from registration at key stages of their business cycle; and
  - Ways to allow issuers to transition from exempt offering types to registered public offerings without undue friction or delay.

Overview of Offering Alternatives

Alternatives

- We will review the following alternatives:
  - Section 4(a)(2) offerings;
  - Rule 506(b) offerings;
  - Regulation A offerings;
  - Crowdfunding; and
  - Rule 506(c) offerings
- We will not discuss Rule 144A, given that the Rule 144A market generally is quite different

Section 4(a)(2)

- Transactional exemption
- Issuer exemption
  - Most utilized exemption
  - Application of the private placement exemption, however, has been the subject of significant debate due in large part to the brevity of its wording
  - Not a "public offering" has been defined by case law and SEC interpretation and one may look to safe harbors as well
- Restricted securities – securities sold in a private placement may not be resold absent registration or exemption from registration

Section 4(a)(2) *(cont'd)*

- **Amount of offering:** amount is unlimited
- **By?** any issuer, whether reporting or non-reporting, can rely on Section 4(a)(2)
- **Who can invest?** sophisticated investors who can fend for themselves
- **What is the investor cap**? no applicable cap
- **Is an intermediary required?** effectively, yes, given that the issuer cannot use general solicitation or general advertising; issuer could raise capital from investors with whom it has a pre-existing substantive relationship
- **Manner of offering:** the offering cannot involve general solicitation or general advertising
- **Offering disclosure requirements:** none
- **Reporting following the offering:** none; no requirement to file a Form D
- **Transfer restrictions:** securities will be restricted securities

Section 4(a)(2) *(cont'd)*

- **Bad actor disqualification:** the disqualification is not applicable to Section 4(a)(2) offerings
- **Manner of offering:** generally, a Section 4(a)(2) offering will involve a placement agent; the placement agent will identify investors. Investors will conduct their own diligence review
- **Documentation:** there may or may not be an offering memorandum; the investors will sign a securities purchase agreement with the issuer; each investor will make payment to the issuer directly, generally
- **State blue sky:** the securities are not "covered securities", however, given offerings are limited to accredited investors or institutional accredited investors, typically state exemptions will be available

Rule 506 safe harbor

- Rule 506 is the most widely used exemptive rule under Regulation D, accounting for the overwhelming majority of capital raised under Regulation D.
- Traditional requirements of a Rule 506 private placement include:
  - No dollar limit on size of transaction.
  - Unlimited number of accredited investors and no more than 35 unaccredited investors.
  - No general solicitation or advertising (*now prohibition against general solicitation has been eliminated for 506(c) offerings*).
  - Resale limitations.
  - Disclosure required for non-accredited investors.
  - Form D filing within 15 days of first sale of securities.
  - Good faith effort to comply (Rule 508).

Rule 506(b)

- "Traditional" Rule 506 offering
- **Amount of offering:** unlimited
- **By?** Rule 506(b) can be used by reporting and non-reporting issuers, so long as issuer and other covered persons are not subject to bad actor disqualification
- **Who can invest?** Accredited investors and a limited number of non-accredited investors; in practice, offerings are limited to accredited investors
- **What is the investor cap?** None.
- **Is an intermediary required?** Not technically required; however, given that the issuer cannot use general solicitation or general advertising; issuer could raise capital from investors with whom it has a pre-existing substantive relationship
- **Manner of offering:** the offering cannot involve general solicitation
- **Reporting following the offering:** filing of a Form D

Rule 506(b) *(cont'd)*

- **Bad actor disqualification:** the issuer will be required to obtain information from all covered persons
- **Documentation:** there may or may not be an offering memorandum; the investors will sign a securities purchase agreement with the issuer; each investor will make payment to the issuer directly, generally
- **State blue sky:** securities sold pursuant to Rule 506(b) are "covered securities"

Rule 506(c)

- Rule 506(c) permits the use of general solicitation, subject to the following conditions:
  - The issuer must take reasonable steps to verify that the purchasers of the securities are accredited investors;
  - All purchasers of securities must be accredited investors, either because they come within one of the enumerated categories of persons that qualify as accredited investors or the issuer reasonably believes that they qualify as an accredited investor, at the time of the sale of the securities; and
  - The conditions of Rule 501 and Rules 502(a) and 502(d) are satisfied

Rule 506(c) *(cont'd)*

- Reasonable steps to verify investor status
- Principles-based guidance includes a list of factors to consider:
  - *The nature of the purchaser*. The SEC describes the different types of accredited investors, including broker-dealers, investment companies or business development companies, employee benefit plans, and wealthy individuals and charities
  - *The nature and amount of information about the purchaser*. Simply put, the SEC states that "the more information an issuer has indicating that a prospective purchaser is an accredited investor, the fewer steps it would have to take, and vice versa"
  - *The nature of the offering*. The nature of the offering may be relevant in determining the reasonableness of steps taken to verify status, i.e., issuers may be required to take additional verification steps to the extent that solicitations are made broadly, such as through a website accessible to the general public, or through the use of social media or email

Rule 506(c) *(cont'd)*

- Final rule does not provide for a safe harbor; however, it does set out a supplemental non-exclusive list of methods that may be used to satisfy the verification requirement, including:
  - A review of IRS forms for the two most recent years and a written representation regarding the individual's expectation of attaining the necessary income level for the current year;
  - A review of bank statements, brokerage statements, tax assessments, etc. to assess assets, and a consumer report or credit report from at least one consumer reporting agency to assess liabilities;
  - A written confirmation from a registered broker-dealer, RIA, CPA, etc.
  - For existing investors (pre-506(c) effective date), a certification

Rule 506(c) *(cont'd)*

- **Amount of offering:** unlimited
- **By?** Rule 506(c) can be used by reporting and non-reporting issuers, so long as issuer and other covered persons are not subject to bad actor disqualification
- **Who can invest?** Accredited investors only
- **What is the investor cap?** None
- **Is an intermediary required?** Not technically required; easier for an issuer to conduct a Rule 506(c) offering on its own
- **Manner of offering:** involves general solicitation
- **Reporting following the offering:** filing of a Form D
- **Bad actor disqualification:** the issuer will be required to obtain information from all covered persons
- **Documentation:** there may or may not be an offering memorandum; the investors will sign a securities purchase agreement with the issuer; each investor will make payment to the issuer directly generally
- **State blue sky:** securities sold pursuant to Rule 506(b) are "covered securities"

"Accredited investor crowdfunding"

- Many "matchmaking portals" rely on Rule 506(b) to conduct internet-based offerings solely to accredited investors
- These offerings are structured such that the matchmaking portal makes an offer only to accredited investors with which the portal has established or has a pre-existing substantive relationship
- Issuer specific or offering specific information is not generally available and is made available only to "members" or on a password-protected basis to those investors known to the portal
- An accredited investor crowdfunded offering relies on the guidance provided in pre-JOBS Act no-action letters (*IPONet*, *Lamp Technologies*, etc.) and affirmed recently in C&DIs on general solicitation, as well as in a recent no-action letter, *CitizenVC*

Questions arising from concept release and recommendations

- Areas as to which the SEC seeks input include:
  - Whether the existing framework provides appropriate options for different types of issuers to raise capital at key stages of their business cycles;
  - Whether the existing framework or the exemptions themselves are too complex, either because of the number of exemptions or because of the way in which they are structured;
  - Whether offers should be deregulated;
  - How technology impacts decisions to rely on a specific exemption; and
  - Whether more investors should be able to participate in exempt offerings.

Questions arising from concept release and recommendations *(cont'd)*

- Areas as to which the SEC seeks input on Rule 506 include:
  - Whether Rules 506(b) and 506(c) should be combined into one exemption and, if so, what features of the existing rules should be retained
  - Whether it is important to allow non-accredited investors to be able to participate in a Rule 506(b) offering
  - Whether the information requirements of Regulation D should be aligned with those of other exempt offerings
  - Whether the SEC should define general advertising and general solicitation
  - Whether investment limits should be added for nonaccredited investors
  - Whether non-accredited investors should be allowed to participate in an offering that involves a general solicitation

Regulation A

- **Amount of offering:** Tier 1 up to $20 million in 12-month period, Tier 2 up to $50 million in 12-month period
- **By?** Eligible issuers are issuers organized in and with their principal place of business in the United States or Canada, other than funds, blank check companies, issuers subject to various disqualifications
- **Who can invest?** Accredited and non-accredited investors
- **What is the investor cap?** A non-accredited natural person is subject to an investment limit and must limit purchases to no more than 10% of the greater of the investor's annual income and net worth, determined as provided in Rule 501 of Regulation D (for non-accredited, non-natural persons, the 10% limit is based on annual revenues and net assets). The investment limit does not apply to accredited investors and will not apply if the securities are to be listed on a national securities exchange at the consummation of the offering
- **Is an intermediary required?** No
- **Manner of offering:** the offering may involve "testing the waters"

Regulation A *(cont'd)*

- **Offering disclosure requirements:** an issuer must prepare and file with the SEC and have qualified an offering statement on Form 1-A.
- Part I (Notification) requires certain basic information regarding the issuer, its eligibility, the offering details, the jurisdictions where the securities will be offered, and sales of unregistered securities.
- Part II (Offering Circular)
  - Part II contains the narrative portion of the Offering Circular and requires disclosures of basic information about the issuer; material risks; use of proceeds; an overview of the issuer's business; an MD&A type discussion; disclosures about executive officers and directors and compensation; beneficial ownership information; related party transactions; and a description of the offered securities.
  - This is similar to Part I of Form S-1 and an issuer can choose to comply with Part I of Form S-1 in connection with its Offering Circular.
    - An issuer that chooses to list its securities concurrent with the completion of a Regulation A offering will be required to use Part I of Form S-1 in connection with the Offering Circular
    - Other Tier 2 issuers also are likely to use Part I of Form S-1 as well

Regulation A *(cont'd)*

- **Financial statement requirements:** differ for Tier 1 and Tier 2 offerings:
  - Tier 1 and Tier 2 issuers must file balance sheets and other required financial statements as of the two most recently completed fiscal year ends, or for such shorter time as they have been in existence, subject to certain exceptions.
  - The financial statements for an issuer in a Tier 2 offering are required to be audited by an independent auditor that need not be PCAOB-registered, except as noted below.
  - An issuer in a Tier 2 offering that seeks to have a class of securities listed on a national securities exchange concurrent with the Regulation A offering must include financial statements audited in accordance with PCAOB standards by a PCAOB-registered firm.
- **Advertising:** an issuer may solicit any investors (not subject to the requirements applicable to EGCs, for example); materials may be used both before and after the offering statement is filed
- **Intermediary restrictions and requirements:** an issuer can conduct a Regulation A offering with or without a financial intermediary

Regulation A *(cont'd)*

- **Reporting following the offering:** Tier 1 issuers would have no ongoing reporting obligation, other than to file an exit report on Form 1-Z within 30 days after the termination or completion of a Regulation A-exempt offering. Tier 2 issuers will be subject to ongoing reporting. Tier 2 issuers would be required to file:
  - Annual reports on Form 1-K (120 calendar days after the issuer's fiscal year end);
  - Semi-annual reports on Form 1-SA (90 calendar days after the end of the first six months of the issuer's fiscal year);
  - Current reports on Form 1-U;
  - Special financial reports on Form 1-K and Form 1-SA; and
  - Exit reports on Form 1-Z.
- **Bad actor disqualification:** the issuer will be required to obtain information from all covered persons
- **State blue sky:** securities sold pursuant to Tier 1 will be subject to state blue sky requirements; securities sold pursuant to Tier 2 will be "covered securities"
- **Transfer restrictions:** securities sold pursuant to Regulation A are not "restricted securities"

Questions arising from concept release and recommendations *(cont'd)*

- Areas as to which the SEC is seeking input include whether:
  - There is anything about the Regulation A process that is unduly burdensome
  - The costs associated with conducting a Regulation A offering dissuade issuers from relying on the exemption
  - The Tier 2 offering limit should be increased
  - The eligible categories of issuers and/or the types of eligible securities should be expanded
  - To eliminate or change the individual investment limits for non-accredited investors in Tier 2 offerings
  - To permit the use of quick response (QR) codes (machine-readable images that contain data and can direct the user to a website or application) in lieu of hyperlinks to an offering circular

Regulation Crowdfunding

- **Amount of offering:** up to $1.07 million in a 12-month period through crowdfunding
- **By?** Issuers that are not reporting companies, not funds, and not subject to disqualification
- **Who can invest?** Accredited and non-accredited investors
- **Is there an investor cap?** An investor is subject to an investment limit on amounts invested in any 12-month period through crowdfunding equal to:
  - The greater of: $2,200 or 5% of the lesser of the investor's annual income or net worth if either annual income or net worth is less than $107,000; or
  - 10% of the lesser of the investor's annual income or net worth, not to exceed an amount sold of $100,000, if both annual income and net worth are $107,000 or more
- **Is an intermediary required?** Yes. An issuer can only engage in crowdfunding through a broker-dealer or a funding portal, and can use only one intermediary for an offering
- **Manner of offering:** the offering must be conducted only through the platform

Regulation Crowdfunding *(cont'd)*

- **Offering disclosure requirements:** an issuer that elects to engage in a crowdfunded offering will be required to prepare initial disclosure about the issuer and the offering on Form C
- Form C requirements resemble the Form 1-A requirements for a Regulation A offering and include a discussion of:
  - Use of Proceeds;
  - The Targeted Offering Size;
  - Offering Price;
  - Business;
  - Directors and officers;
  - Beneficial Ownership and Capital Structure;
  - Indebtedness;
  - Related party transactions;
  - Exempt offerings;
  - Risk factors;
  - Transfer restrictions; and
  - Management's Discussion and Analysis.

Regulation Crowdfunding *(cont'd)*

- **Financial Statement Requirements:** in addition, a Form C must include certain financial statements prepared in accordance with U.S. GAAP. Audited financial statements must be conducted in accordance either with AICPA standards or PCAOB standards. Requirements depend on the target offering size as follows:
  - **$107,000 or less**: the amount of total income, taxable income and total tax or equivalent line items, as reported on the federal tax forms filed by the issuer for the most recently completed year (if any), certified by the principal executive officer of the issuer, and the financial statements of the issuer, also certified by the principal executive officer. If financial statements of the issuer are available that have either been reviewed or audited by a public accountant independent of the issuer, then, these financial statements must be provided instead of the materials described in the preceding sentence.
  - **More than $107,000 and less than $535,000**: financial statements of the issuer reviewed by a public accountant independent of the issuer. If financial statements of the issuer are available that have been audited by a public accountant independent of the issuer, the issuer must provide those instead of the reviewed statements.

Regulation Crowdfunding *(cont'd)*

- **More than $535,000**: financial statements of the issuer audited by a public accountant independent of the issuer; provided, however, that for issuers that are first-time issuers, offerings that have a target offering amount of more than $535,000 but not more than $1.07 million, financial statements of the issuer reviewed by a public accountant independent of the issuer. If audited statements are available, those must be provided instead
- **Advertising:** an issuer's ability to advertise or promote the offering is limited to certain offering notices (basic offering details) and certain communications with potential investors made through the platform
- **Intermediary restrictions and requirements:** the intermediary is subject to educational and other obligations and limitations

Regulation Crowdfunding *(cont'd)*

- **Reporting following the offering:** until an issuer terminates its reporting obligations, it is required to file amendments for material changes (C/A), periodic updates (C-U) and annual filings (C-AR)
- **Transfer restrictions:** securities sold in such an offering are subject to certain transfer restrictions for one year

Questions arising from concept release and recommendations *(cont'd)*

- Areas as to which the SEC seeks input include whether:
  - The requirements of Regulation Crowdfunding appropriately address capital formation and investor protection concerns
  - The costs associated with conducting a Regulation Crowdfunding offering dissuade issuers from relying on the exemption or intermediaries from facilitating offerings
  - Changes should be made to Regulation Crowdfunding, such as increasing the offering limit
  - The issuer eligibility requirements should be expanded
  - The exemption under Section 12(g) of the Exchange Act for securities issued in a Regulation Crowdfunding offering should be modified to conform to the exemption for Regulation A Tier 2 securities

Framework for Evaluating Alternatives

Who is the issuer?

- Is the issuer an SEC-reporting company?
  - If so, the issuer will want to limit its focus to Section 4(a)(2), Rule 506(b), and Rule 506(c). Generally, an SEC-reporting company will find it challenging to undertake a Rule 506(c) offering. Although Regulation A is now available to reporting companies, its use may still be limited in this context.
- What if the issuer is a private, non-reporting issuer?
  - If the issuer is not an SEC-reporting company and the issuer is domiciled in the United States, the issuer will want to consider Regulation Crowdfunding, intrastate crowdfunding, Rule 504, and Regulation A, in addition to Section 4(a)(2), Rule 506(b), and Rule 506(c).

What are the issuer's goals?

- Is the issuer principally focused on raising additional capital? If so, how much?
  - As discussed in prior slides, certain offering exemptions are available only for offerings under a specified dollar threshold
  - Can various exemptions be used? Are there integration safe harbors?
- Are there goals beyond merely raising the capital?
  - For example, is the issuer seeking to attract particular types of investors?
  - Who are the investors? Where are the investors?
  - Is the issuer seeking to make itself better known generally by making information about itself available broadly through SEC filings?
  - Is the issuer concerned about liquidity opportunities for existing securityholders? Liquidity opportunities for the new investors?
- Is the contemplated offering only a part of a more comprehensive funding plan?

Who are the potential investors?

- Does the issuer have existing institutional investors?
  - If the issuer is an established company, likely, it will have undertaken prior rounds of financing and will have existing investors, some of which may be venture or private equity investors or angel investors. Such investors may have a strong preference for limiting participation to other institutional or professional investors, and likely will not want to see broad outreach to non-accredited investors that may not be known to the issuer
- If the issuer is an emerging company, does it want to seek out institutional or strategic investors? Does it want to attract investors from among its customers?
  - Even early stage companies may choose to limit their investor base to institutional accredited investors and accredited investors known to the company or introduced to the company by a financial intermediary (placement agent). There may be strong reasons for doing so—for example, the company may want advice from its institutional investors, may want institutional investors that can serve on the board of directors or board of advisors, or may want to limit the number of holders to professional investors that know the sector and are accustomed to making investments in early stage companies

Who are the potential investors? *(cont'd)*

  - A company may have some concerns about reaching out to investors with whom it does not have a pre-existing relationship. For example, investors may not be experienced in investing in early stage companies and may have unrealistic expectations or require a level of engagement that distracts management from its responsibilities. The company also may find it challenging to keep track of its investors.
  - Consumer product oriented companies, by contrast, may want to have customers among their shareholders.
- A fundamental question, therefore, will be whether the issuer wants to include non-accredited investors in the offering.
  - If the issuer would like to include non-accredited investors, it will be limited to Rule 506(b) or Rule 504 (subject to preparation of certain disclosures), intrastate crowdfunding, Regulation Crowdfunding or Regulation A.
  - In the case of Regulation Crowdfunding and Regulation A, the investor will be subject to investor caps.

Will an intermediary be used?

- Is the issuer reaching out to existing investors? To investors with which the issuer already has a pre-existing relationship? Or seeking to reach potential investors identified by an intermediary or by the issuer?
  - This is closely tied to the type of investor that the issuer would like to identify
- Do the rules require that an intermediary be used?
  - In a crowdfunded offering under Regulation Crowdfunding, an issuer is required to use an intermediary that is either a broker-dealer or a funding portal
  - In offerings without general solicitation, although there is no express requirement to do so, it is very challenging for an issuer to conduct an exempt offering without a financial intermediary
  - In an offering using general solicitation, such as a Rule 506(c) offering or a Regulation A offering, an issuer could undertake the offering without a financial intermediary
  - It will be essential for the issuer to consider whether it engages an intermediary, whether the intermediary is a "matchmaking portal" or other unregistered person (not required to be registered as a broker-dealer), or a broker-dealer
- Why is the issuer selecting a particular type of intermediary?
  - Consider whether a matchmaking portal or other unregistered person will be able to provide the anticipated results

Is general solicitation important?

- Will testing the waters or a widespread campaign be essential to the offering?
  - The issuer should consider carefully whether general solicitation is important—for example, is it necessary in order to reach the customer base? Are the customers likely to be investors?
  - If general solicitation is essential, then, the choices are limited to Regulation Crowdfunding, intrastate crowdfunding, Rule 504 (depending on whether the issuer uses the state registration approach), Rule 506(c), and Regulation A
  - Now, if the issuer wants to use general solicitation and must include non-accredited investors, then, that eliminates Rule 506(c) as an alternative
  - Then, the issuer might want to compare and contrast as among the remaining alternatives, the required offering disclosures and financial statement requirements
  - Is "testing the waters" prior to investing resources in a Tier 1 or Tier 2 Regulation A offering important to the issuer?

What offering disclosures will be used?

- Does the issuer understand the information and disclosure requirements associated with the various exemptions when non-accredited investors are proposed to be included?
- Is the issuer prepared to undertake the preparation of a Form C for an offering made pursuant to Regulation Crowdfunding or of a Form 1-A for a Regulation A offering?
  - An issuer should review closely the offering requirements associated with Form C and/or Form 1-A
  - Both require significant narrative descriptions of the company's business, management, financial results, and related matters
  - Has the issuer considered the costs associated with the preparation of the required financial statements? Has it engaged accountants to assist?
- Has the issuer considered the ongoing reporting requirements once it has completed the financing?

Rule 506(c), Crowdfunding and Reg A

- These three types of offerings, which have very different requirements, often are incorrectly referred to as "crowdfunding" transactions.
- Of course, all three have in common the ability to use general solicitation and the ability to "test the waters," but, that's where the similarities end.
- For an issuer, it will be important to distinguish among the three:
  - In a Rule 506(c) offering, sales may be made only to accredited investors, there is no specific disclosure requirement
  - In a Regulation A offering, whether Tier 1 or Tier 2, the issuer will be required to prepare an offering statement (Form 1-A) and have that offering statement qualified before the offering can commence. Similarly, Regulation Crowdfunding requires the preparation of a Form C. The disclosure requirements as between the two are comparable; however, the offering thresholds are quite different as is the conduct of the offering

Tier 2 of Regulation A versus IPO

- An issuer may consider a Tier 2 Regulation A offering (up to $50 million in proceeds) and do so with or without pursuing a listing on a national securities exchange
- If an issuer intends to list on an exchange, then, it should take into account that financial statements will be required to be prepared that are PCAOB compliant
- Once an issuer undertakes a Tier 2 offering with a listing on a national securities exchange, the issuer will become subject to the corporate governance requirements of the exchange, as well as full Sarbanes-Oxley corporate governance requirements (albeit as an "EGC" issuer)
- In many respects, this outcome will be similar to the outcome if the issuer had undertaken a Title I IPO as an EGC
- There are some important differences to consider

Integration issues

- An offering cannot be viewed in isolation
- Invariably, an offering is just a component of the issuer's broader funding strategy
- Given volatile markets and the "newness" of many of these offering exemptions, it will be important for an issuer to understand how the issuer can (or if it can) change course if an offering approach is unsuccessful or proves to be undesirable and pursue a different approach
- Also, an issuer will want to think carefully about what's next....If the issuer intends to pursue another offering within a six-month period, has it considered the integration safe harbors that are available to it?

Integration

Integration

- Prevents circumvention of registration requirements by separating single non-exempt offering into several exempt offerings
- Six-month safe harbor – Rule 502(a)
- SEC's integration doctrine may apply to an offering that otherwise qualifies for an exemption under Regulation D

Integration – five-factor test

- Under SEC's integration doctrine, the following factors ("five factors") are considered in determining whether one sale of securities by an issuer will be integrated with (i.e., treated as part of the same offering as) a prior or subsequent offer or sale of securities by the issuer:
  - Part of a single financing plan;
  - Issuances of the same class of securities;
  - Sales occur at or about the same time;
  - Same type of consideration is received; and
  - Proceeds will be used for same general purpose.

Integration – safe harbors

- Safe harbor for offshore offerings
  - Regulation S ("Reg S") provides that offshore sales under Reg S generally are not integrated with offerings in the United States.
  - In connection with the SEC's adoption of final rules relaxing the prohibition on general solicitation in Rule 144A offerings, the SEC clarified that a general solicitation in connection with a Rule 144A/Regulation S offering should not be considered (on its own) to constitute a "directed selling effort" for purposes of Regulation S
  - Rule 152 provides that the phrase "transactions by an issuer not involving any public offering" contained in Section 4(a)(2) of the Securities Act will be deemed to apply to transactions not involving any public offering at the time of the transactions although the issuer subsequently decides to make a public offering and/or files a registration statement.

Rule 155

- Rule 155(b) – Private → Registered
  - Safe harbor for changing a private offering into a registered offering so long as certain conditions are met.
- Rule 155(c) – Registered → Private
  - Safe harbor for abandoning a registered offering and conducting a private offering so long as certain conditions are met.

Regulation A

- The SEC's final rules make clear that a Regulation A offering will not be integrated with:
  - Prior offers or sales of securities; or
  - Subsequent offers or sales of securities that are:
    - Registered under the Securities Act, except as provided in Rule 255(e);
    - Made in reliance on Rule 701;
    - Made pursuant to an employee benefit plan;
    - Made in reliance on Regulation S;
    - Made pursuant to Section 4(a)(6) of the Securities Act; or
    - Made more than six months after the completion of the Regulation A offering.
- The SEC reaffirmed guidance that was included in the proposing release, which is consistent with the guidance regarding integration provided in Release 33-8828.

Regulation A *(cont'd)*

- If an issuer registers an offering under the Securities Act after soliciting interest in a contemplated, but subsequently abandoned, Regulation A offering, the abandoned Regulation A offering would not be subject to integration with the registered offering if the issuer engaged in solicitations of interest only to QIBs and institutional accredited investors permitted by Section 5(d) of the Securities Act.
  - This may impact a Regulation A issuer's approach to test-the-waters communications
- If the issuer engaged in solicitations of interest to persons other than QIBs and institutional accredited investors, an abandoned Regulation A offering would not be subject to integration if the issuer (and any underwriter, broker, dealer, or agent used by the issuer in connection with the proposed offering) waits at least 30 calendar days between the last such solicitation of interest in the Regulation A offering and the filing of the registration statement with the SEC.
- An issuer can integrate a Regulation A offering into a more comprehensive capital-raising plan, which might include a Rule 506 offering, or a Regulation A offering as a first step before undertaking an IPO.

Crowdfunding

- An offering made pursuant to Section 4(a)(6) will not be integrated with another exempt offering that precedes the crowdfunded offering, or that takes place concurrently or subsequently.
- The issuer must ensure that it has satisfied all of the conditions for the exemption that it is claiming for each offering.
- If the issuer is conducting a Rule 506(c) offering (using general solicitation), it must ensure that the Rule 506(c) offerees were not solicited by means of the communications used for the crowdfunded offering.

Rule 147

- Rule 147: the final rules also align the integration safe harbor in Rule 147 with the integration safe harbor in Rule 251(c) of Regulation A
- Under the final rules, offers and sales made pursuant to amended Rule 147 or new Rule 147A will not be integrated with:
  - Prior offers or sales of securities; or
  - Subsequent offers or sales of securities that are:
    - Registered under the Securities Act, except as provided in amended Rule 147(h) or new Rule 147A(h);
    - Exempt from registration under Regulation A;
    - Exempt from registration under Rule 701 under the Securities Act;
    - Made pursuant to an employee benefit plan;
    - Exempt from registration under Regulation S under the Securities Act;
    - Exempt from registration under Section 4(a)(6) of the Securities Act; or
    - Made more than six months after the completion of an offering conducted pursuant to amended Rule 147 or new Rule 147A.

Questions arising from concept release and recommendations *(cont'd)*

- Areas as to which the SEC seeks input include whether:
  - One integration doctrine should apply to all exempt offerings
  - The six-month period in the five-factor test of Rule 502(a) should be shortened
  - The SEC should replace the five-factor test with the newer approach articulated in connection with the more recently adopted exemptions (i.e., whether each offering complies with the requirements of the exemption being relied on for the particular offering)
  - The SEC should adopt additional integration safe harbors
  - Rule 155 should be revised

Accredited Investors

Accredited Investors

- Accredited Investors (Rule 501)
  - Institutional investors such as banks, S+Ls, broker-dealers, insurance companies, investment companies
  - Corporations or trusts with assets in excess of $5 million
    - Not formed for purpose of making the investment (look-through rule)
  - Directors and officers of the issuer
  - Individuals with
    - Income > $200,000 or joint income > $300,000
    - Net worth or joint net worth > $1 million*
  - Entity in which all equity owners are accredited investors

* Dodd-Frank Act of 2010 amended definition to eliminate ability of individuals to include the equity value of primary residences in calculation of net worth

Accredited Investors *(cont'd)*

- The SEC and various advisory groups have sought comment on, and suggested revisions to, the accredited investor definition
  - 2015 SEC Accredited Investor Staff Report
  - Advisory Committee on Small and Emerging Companies
  - 2017 Treasury Report
- Many of these recommendations have focused on adding additional categories to the current definition

Questions arising from concept release and recommendations *(cont'd)*

- Areas as to which the SEC seeks input include whether:
  - The current definition should be retained
  - The financial thresholds should be adjusted
  - The definition of spouse should be expanded to include spousal equivalents
  - Other measures of sophistication should be included that would allow a person to qualify as an accredited investor
- In addition, the SEC seeks comment on whether revisions should be made to other aspects of the definition of accredited investor, including whether:
  - Other entities should be eligible to qualify as accredited investors in addition to those enumerated in the existing rule
  - The current $5,000,000 asset test should be replaced by an investment test

Resale of Securities

Existing Resale Exemptions

- Resale exemptions include:
  - Rule 144: Non-exclusive safe harbor for public resale of restricted and control securities subject to compliance with certain conditions
  - "Section 4(a)(1½)": Technique developed by bar to facilitate private resales similar to 4(a)(2) private placements
  - Rule 144A: Private resales to QIBs
  - Regulation S under Securities Act: Resales of securities in "offshore transactions" with no "directed selling efforts" in the United States
  - Section 4(a)(7)

Rule 144

- Rule 144 provides a non-exclusive safe harbor for public resales of restricted securities
  - Without the types of limitations imposed by the rule, investors in a private placement (and their transferees) may be deemed to be taking with a view to distribution, who would be unable to rely on Section 4(a)(1) or, in the case of dealers, Section 4(a)(3), of the Securities Act
  - Adopted in 1972, Rule 144 has been amended from time to time (most recently in December 2007), generally to make it easier for holders to take advantage of the rule
- If a holder satisfies all of Rule 144's applicable conditions, the holder is generally deemed not to be an "underwriter"
  - Conditions differ for affiliates and non-affiliates
  - Generally not available for business combination-related shell companies or asset-backed issuers (one year look-back)
- Securities sold pursuant to Rule 144 are no longer "restricted securities" and may be resold freely by non-affiliate purchasers of the securities

Private Resale Alternatives for Restricted Securities

- An affiliate may not want, or may be unable, to comply with all of the conditions of Rule 144. There are two "private" resale exemptions that the affiliate may use — Rule 144A and the Section 4(a)(1½) exemption.
- Why are these "private" resales?
  - Because the transferee will receive a restricted security, or a security subject to contractual restrictions on transfer.
- Rule 144A:
  - Transfers to qualified institutional buyers ("QIBs");
  - Transferee's security is a restricted security under Rule 144(a)(3)(iii);
  - All conditions of Rule 144A must be met; some securities and issuers may not be eligible;
  - General solicitation is now allowed, provided that sales are made only to QIBs.

Rule 144A Private Resales

- Why isn't a Rule 144A resale a distribution, causing the seller to be a statutory underwriter? Isn't the transferor acquiring securities from the issuer "with a view to distribution"?
  - 144A resales are not offered to the public;
  - Consequently, they are not distributions, even though the purchaser of the security from the issuer purchased the securities with a view to reselling them;
  - 144A resellers are therefore not underwriters;
  - Persons other than issuers or dealers can rely on Section 4(a)(1), and dealers can rely on Section 4(a)(3) for their 144A resales; and
  - The issuer's Section 4(a)(2) exemption is not tainted by a public distribution

The "4(a)(1½) Exemption"

- The Section 4(a)(1½) exemption has evolved in practice, without the benefit of any official rulemaking.
- It is a hybrid consisting of:
  - A Section 4(a)(1) exemption that exempts transactions by anyone other than an "issuer, underwriter or dealer," and
  - A Section 4(a)(2) analysis to determine whether the seller is an "underwriter," i.e., whether the seller purchased the securities with a view to distribution.
- In 1980, the SEC recognized the Section 4(a)(1½) exemption, which although not specifically provided for in the Securities Act ,"[is] clearly within its intended purpose," provided that the established criteria for sales under both Sections 4(a)(1) and 4(a)(2) are satisfied.

Section 4(a)(7) Exemption for Resales

- The FAST Act codifies a specific resale exemption, Section 4(a)(7)
- The exemption provides certainty for transactions that meet the following requirements:
  - Each purchaser is an accredited investor;
  - Neither the seller nor any person acting on the seller's behalf engages in any form of general solicitation; and
  - In the case of an issuer that is not a reporting company, exempt from the reporting requirements pursuant to Rule 12g3-2(b), or a foreign government eligible to register securities on Schedule B, at the request of the seller, the seller and a prospective purchaser obtain from the issuer reasonably current information, including:
    - The issuer's exact name (as well as the name of any predecessor);
    - The address of the issuer's principal place of business;
    - The exact title and class of the offered security, its par or stated value, and the current capitalization of the issuer;
    - Details for the transfer agent or other person responsible for stock transfers;
    - A statement of the nature of the issuer's business that will be presumed current if it is as of 12 months before the transaction date;

Section 4(a)(7) Exemption for Resales *(cont'd)*

- The issuer's officers and directors;
- Information about any broker, dealer or other person being paid a commission or fee in connection with the sale of the securities;
- The issuer's most recent balance sheet and profit and loss statement and similar financial statement for the two preceding fiscal years during which the issuer has been in business, prepared in accordance with GAAP or, in the case of a foreign issuer, IFRS. The balance sheet will be deemed reasonably current if it is as of a date not less than 16 months before the transaction date and the profit and loss statement shall be deemed reasonably current if it is as of a date not less than 12 months preceding the date of the issuer's balance sheet. If the balance sheet is not as of a date less than six months before the transaction date, it must be accompanied by additional statements of profit and loss for the period from the dates of such balance sheet to a date less than six months before the transaction date; and
- If the seller is an affiliate, a statement regarding the nature of the affiliation accompanied by a certification from the seller that it has no reasonable grounds to believe that the issuer is in violation of the securities laws or regulations.

Section 4(a)(7) Exemption for Resales *(cont'd)*

- The Section 4(a)(7) exemption is not available:
  - if the seller is a direct or indirect subsidiary of the issuer;
  - if the seller or any person that will be compensated in connection with the transaction, such as a broker-dealer, is subject to the bad actor disqualification provisions included in Rule 506 or described under Section 3(a)(39) of the Exchange Act;
  - if the issuer is a blank check, blind pool, shell company, special purpose acquisition company, or in bankruptcy or receivership;
  - the transaction relates to a broker-dealer's or underwriter's unsold allotment; or
  - the security that is the subject of the transaction is part of a class of securities that has not been authorized and outstanding for at least 90 days prior to the transaction date.
- The securities sold in a Section 4(a)(7) resale transaction will be considered "restricted securities" and "covered securities" for blue sky purposes.
- A transaction effected pursuant to this exemption will not be deemed to be a "distribution" under the Securities Act.

Questions arising from concept release and recommendations *(cont'd)*

- Areas as to which the SEC seeks input include whether:
  - Concerns about secondary market liquidity have a significant effect on issuers' decision-making with regard to primary capital-raising options
  - Secondary market liquidity affects the decision-making of individual investors
  - Issuers of exempt securities are concerned that secondary trading could lead to a high number of record holders, resulting in a requirement to register under Section 12(g) of the Exchange Act
  - Rule 144 should be revised to reduce the holding period requirement
  - The SEC should expand the number of offerings that qualify for federal preemption of blue sky laws
  - Other steps could be taken to enhance secondary trading liquidity of securities issued in exempt transactions

What's next?

- While it is expected that the SEC will move forward expeditiously to address many of the topics that are the subject of the Concept Release, this process will still take time
- Certain matters may be easier to address promptly, such as the accredited investor definition, the Rule 144 holding period, and the integration guidance

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